Employee Benefit Plans

Explanation No. **11**

Employee and Matching Contributions

The purpose of Worksheet Number 11 (Form 8799) and this explanation is to identify major problems concerning the special nondiscrimination requirements that apply to employee and matching contributions.

Section 401(m) of the Internal Revenue Code, which was added by the Tax Reform Act of 1986, established a special nondiscrimination test with respect to the amount of employee and matching contributions under a plan. Worksheet Number 11 and this explanation are to be used in those plans which are subject to the requirements of section 401(m).

Generally a "Yes" answer to a question on the worksheet indicates a favorable conclusion, while a "No" answer signals a problem concerning plan qualification. This rule may be altered by specific instructions for a given question. Please explain any "No" answer in the space provided on the worksheet.

The sections cited at the end of each paragraph of this explanation are, except as otherwise noted, to the Internal Revenue Code and the final Income Tax Regulations. Part VII is new. Other additions since the prior version of this document have been underlined.

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The technical principles in this publication may be changed by future regulations or guidelines.

1. Applicability

Section 401(m) of the Code contains special nondiscrimination requirements relating to the amount of employee contributions and matching employer contributions under a plan. For plan years beginning after 1986, a plan will fail to satisfy the general nondiscrimination requirements under section 401(a)(4) unless it satisfies the special nondiscrimination requirements of section 401(m).
401(m)(1)
1.401(m)-1(a)

a. Defined Contribution Plans

(i) A plan is subject to the requirements of section 401(m) if it provides for employee or matching contributions. For purposes of section 401(m), an "employee contribution" includes any contribution that is designated or treated as an after-tax contribution and that is allocated to an individual account to which actual earnings and losses are allocated, including contributions to the defined contribution portion of a plan described in section 414(k). In addition, employee contributions include (i) employee contributions to a qualified cost of living arrangement (COLA) under section 415(k)(2)(B); (ii) employee contributions applied to the purchase of life insurance protection or survivor benefit protection under a defined contribution plan; and (iii) employee contributions to a section 403(b) annuity contract. Employee contributions do not include repayment of loans, or buy-backs of benefits.

A matching contribution is any employer contribution (including discretionary contributions) made on behalf of an employee on account of an employee contribution to the plan. Matching contributions thus include employer contributions conditioned on the employee making a contribution even if the amount of the employer's contribution is not determined with reference to the amount of the employee's contribution. Forfeitures allocated on the basis of employee or matching contributions are also matching contributions under section 401(m). Any employer contribution which is used to satisfy the minimum contribution requirements of section 416(c)(2) is not a matching contribution for the purposes of section 401(m), regardless of whether it is allocated on the basis of employee contributions.

(ii) Section 401(k) of the Code applies a special nondiscrimination test (the actual deferral percentage, or ADP, test) to elective contributions (deferrals) under a qualified cash or deferred arrangement (CODA). Elective contributions are treated as employer contributions and are not tested under section 401(m). (However, also see Part II, below, regarding the use of elective contributions to satisfy section 401(m).) A CODA that would otherwise fail the ADP test because of excess elective contributions by highly compensated employees may satisfy the test by recharacterizing the excess contributions as employee contributions. These recharacterized amounts are subject to the nondiscrimination test of section 401(m). (Note that a plan with a CODA may not limit employee contributions to those resulting from recharacterization. See Worksheet #12.) Employer contributions (including discretionary contributions) or forfeitures that are allocated on the basis of an employee's elective contributions to a CODA are also considered matching contributions under section 401(m).
401(m)(4)
1.401(m)-1(f)(6), and (12)

b. Defined Benefit Plans

Employee contributions generally do not include contributions to a defined benefit plan unless these contributions are allocated to a separate account as described above, such as voluntary employee contributions. The following employee contributions are deemed contributed to a defined contribution plan and are thus subject to the requirements of section 401(m):

1. Employee contributions to the defined contribution portion of a plan described in section 414(k);
2. Employee contributions to a qualified COLA described in section 415(k)(2)(B).

401(m)(4)
1.401(m)-1(f)(6)

II. Discrimination

a. A plan which provides for employee or matching contributions must satisfy the actual contribution percentage (ACP) test set forth in section 401 (m)(2)(A) of the Code. For calendar years beginning after December 31, 1996, a plan subject to section 401(m) is deemed to satisfy the ACP test if it contains, and complies in operation with, "SIMPLE" provisions or for plan years after 12/31/98, "Safe Harbor CODA" provisions. SIMPLE provisions are described in sections 401(k)(11) and 401(m)(10) of the Code and can only be in plans containing a CODA. See Worksheet #12. Safe Harbor CODA provisions are described in section 401(k)(12) and 401(m)(11). See Part VII of this Explanation, and Part X of Explanation #12. For plan years beginning after December 31, 1996, the ACP test compares the average of the actual amounts contributed for the plan year, as a percentage of compensation, on behalf of the eligible highly compensated employees to the average of the actual amounts contributed, again as a percentage of compensation, on behalf of the eligible non-highly compensated employees for the prior year. The plan year being tested is sometimes referred to as the "testing year," and this method of performing the ACP test, the "prior year testing method." (See explanation V.c. for the definition of compensation.) The ACP test is computed by first separately calculating the actual contribution ratios of each eligible employee and then averaging the ratios of all eligible employees in the highly compensated and non-highly compensated groups. The individual ratios as well as the group percentages must be calculated to the nearest one-hundredth of one percent. The percentage contributed on behalf of the eligible highly compensated employees may not exceed the greater of:

1) 1.25 times the percentage contributed on behalf of the eligible non-highly compensated employees for the prior plan year, or
2) The lesser of
   a) two times the percentage contributed on behalf of the eligible non-highly compensated employees for the prior plan year, or

b) two plus the percentage contributed on behalf of the eligible non-highly compensated employees for the prior plan year.

Example:

Ee	Comp.	Ee Contrib.	Match. Contrib.	Contrib. Ratio	Av'g ACP
A	$100,000	$3,650	$1,825	5.48%	
B	$90,000	$2,100.	$1,050	3.50%	4.37%
C	$80,000	$2,200.	$1,100	4.13%	
D	$20,000	$1,000	$500	7.50%	
E	$10,000	$0	$0	0%	2.50%
F	$10,000	$0	$0	0%	

(D, E, and F are non-highly compensated employees, and the figures shown for them in this table are for the prior plan year.)

Under the ACP test, the employer must compare the average ACP of the eligible highly compensated employees (A, B, and C) to the average ACP of the eligible non-highly compensated employees for the prior plan year, using the formulas above to determine whether 1) or 2) is met.

1) 2.50 x 1.25=3.13. Since 4.37 is greater than 3.13, Test 1) is not met.

2) 2.50 x 2=5.00, 2.50 +2=4.50; 4.50 is the lesser of the two. Since 4.37 is less than 4.50, Test 2) is met and the plan passes the ACP test.

For the first plan year a plan is subject to section 401(m), the employer can elect, by so providing in the plan, to use either 3 percent as the average ACP of the non-highly compensated employees or the average ACP for that first plan year. This election is not available if the plan is a "successor plan," i.e., at least half the eligible employees under the plan were eligible under another section 401(m) plan of the employer in the prior year.

If elected by the employer, by so providing in the plan, the ACP test can be applied by comparing the current plan year's average ACP for highly compensated employees with the current, rather than the prior, plan year's average ACP for non-highly compensated employees. This method of ACP testing is called the "current year testing method." Note that the plan must specify whether the prior year or the current year testing method will be used. If the employer has elected to use the current year testing method, switching to prior year testing can only be done if the plan meets the requirements for changing to prior year testing set forth in Notice 98-1 (or superseding guidance). Generally, a plan can switch from current year testing to prior year testing only 1) during the plan's remedial amendment period for the Small Business Job Protection Act of 1996, Pub. L. 104-188, (see Rev. Proc. 99-23, 1999-16 I.R.B. 5); 2) the employer has been involved in a merger, acquisition or similar transaction, and as a result, plans using different testing methods are maintained; and 3) after the plan has been in existence for 5 years. A plan can be amended anytime to use the current year testing method for a future year.

The plan must provide that it will meet the ACP test (unless it contains SIMPLE provisions or meets the ACP test safe harbor provisions). However, in lieu of stating the ACP test, the plan may incorporate by reference the provisions of section 401(m)(2) and the regulations thereunder; and Notices 97-2, 1997-1 C.B. 348, and 98-1, 1998-3 I.R.B. 42, and any superseding guidance. The following discussion summarizes the principal requirements of these regulations and notices. A plan that sets forth the ACP test in lieu of incorporating it by reference must describe the test in a manner which satisfies these requirements, including whether it is using the current or prior year testing method and, if using the prior year testing method, whether 3 percent or the first plan year's average ACP is to be used for the non-highly compensated employees for the first testing year.

The plan must also satisfy the multiple use limitation of section 401(m)(9) that applies if a highly compensated employee participates in an employer's cash or deferred arrangement that is subject to section 401(k) as well as in its plan subject to section 401(m). See VI. However, the multiple use limitation does not apply if a plan contains SIMPLE provisions or satisfies the ADP test safe harbor.

401(m)(2)(A), 401(m)(9), 401(m)(10)
1.401(m)-1(b)(2) and (3) and 1.401(m)-2
Notice 97-2, 1997-1 C.B. 348, Notice 98-1, 1998-3 I.R.B. 42
Notice 98-52, 1998-46 I.R.B. 16

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b. (i) Eligible Employees

The actual contribution ratios of all eligible employees must be taken into account in determining whether a plan satisfies the ACP test. An eligible employee is any employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions. If employee contributions are required as a condition of participation, an employee who would be a participant but for the failure to make the required contribution is considered an eligible employee for the ACP test. Also considered as an eligible employee is an employee whose right to make employee contributions or receive matching contributions has been suspended under the terms of the plan because of a distribution, loan, or an election not to participate in the plan, and an employee who may receive no annual additions because of the limits of section 415. However, if an employee is given a one-time opportunity to elect not to be eligible to make employee contributions and receive matching contributions for the duration of his or her employment and the employee so elects, the employee will not be considered an eligible employee for purposes of section 401(m). Eligible employees who make no employee contributions and who receive no matching contributions have an actual contribution ratio of 0% and these employees may not be excluded from the ACP test even though they may not be participants in the plan.

For plan years beginning after 12/31/98, if an employer elects to apply section 410(b)(4)(B) (relating to the exclusion of employees not meeting the statutory minimum age and service requirements), in determining whether the a CODA meets section 410(b)(1), the plan may provide that, in determining whether the plan meets the ACP test, all eligible employees (other than HCEs) who have not met the minimum age and service requirements of section 410(a)(1)(A) (age 21 or one year of service) are excluded.

401(m)(5)
1.401(m)-1(f)(4)

(ii) Contributions Taken Into Account

In running the ACP test for a plan year, an employee contribution will be taken into account if it is paid to the trust

during the plan year. If an employee pays the contribution to an agent of the plan (such as the employer's payroll officer), the contribution will be considered paid to the trust at the time it is paid to the agent provided it is transmitted to the trust within a reasonable period. For example, a voluntary contribution that is withheld from an employee's December 31 paycheck will be considered contributed to the plan in December even though the payroll officer does not transmit it to the plan until January. Note that Department of Labor regulations at 29 CFR 2510.3-102 require that money withheld from an employee's paycheck be deposited into the plan as of the earliest date such money can be separated from the employer's general assets but not later than the 15th business day after the month the money was withheld.

An excess contribution to a CODA that is recharacterized as an employee contribution will be taken into account for the ACP test in the plan year in which the contribution would have been received in cash if there had not been an election to defer.

A matching contribution will be taken into account for the ACP test for a given plan year only if 1) it is made on account of the employee's elective or employee contributions for that plan year, 2) it is allocated to the employee's account as of any date within that plan year, and 3) it is paid to the trust by the end of the 12th month following the close of that plan year. A matching contribution which does not meet all of these requirements will not be tested under section 401(m). Instead, the contribution must independently satisfy section 401(a)(4) for the plan year of allocation as if it were the only employer allocation for that plan year.

Matching contributions that are forfeited to meet the ACP test or because they relate to excess deferrals or excess contributions (see Worksheet #12) or to excess aggregate contributions (see IV.b., below) are not counted in the ACP test.

Under certain circumstances, an employer may treat elective contributions to a cash or deferred arrangement (i.e., elective deferrals) and certain non-elective contributions (i.e., qualified non-elective contributions or QNECs) as matching contributions for purposes of the ACP test. If the terms of the plan provide for this, then Part lll. of the worksheet should also be completed.

401(m)(3)
1.401(m)-1(b)(1), (4), and (5)
1.401(m)-1(f)(1)

(iii) and (iv) Aggregation

If an employer maintains more than one plan which is subject to the ACP limits of section 401(m), the following aggregation rules apply. When two or more plans are treated as a single plan for purposes of section 401(a)(4) or 410(b) (other than the average benefits test under section 410(b)(2)(A)(ii)), all employee and matching contributions are treated as made under a single plan for purposes of the ACP test as well as for purposes of sections 401(a)(4) and 410(b). Two or more plans subject to section 401(m) may be permissively aggregated if the aggregated plans satisfy the ACP test. Plans may not be permissively aggregated unless they have the same plan year and use the same testing method (either all current or all prior). In this case, the aggregated plans are treated as a single plan for purposes of sections 401(a)(4) and 410(b). Notwithstanding the foregoing, a plan covering collective bargaining unit employees may not be aggregated with one that does not cover such employees, and an ESOP may not be aggregated with a non-ESOP In addition the following single plans must be separated into component plans and tested separately: 1) plans which benefit employees covered by a collective bargaining agreement and employees covered under another or no collective bargaining agreement; 2) plans containing ESOP and non-ESOP portions; 3) plans covering employees of two or more qualified separate lines of business (unless the special rule for employer-wide plans in section 1.414(r)-1(c)(2)(ii) of the regulations apply); and 4) plans covering employees of more than one employer not pursuant to a collective bargaining agreement. However, an employer may elect to treat two or more collective bargaining agreements as one collective bargaining agreement, so that employees covered under different collective bargaining agreements will be treated as if covered under a single plan. This election can only be made if the combinations are reasonable and reasonably consistent from year to year.

When plans are combined, or plan eligibility is changed, and the employer is using the prior year testing method, the average ACP for non-highly compensated employees is the sum of the averages of the employer's plans these employees were in the preceding year, with each such plan's preceding year average reduced to reflect the proportion of non-highly compensated employees from that plan in the present plan.

Example:

> In Year 1, an employer had three plans subject to section 401(m), with the average ACPs for non-highly compensated employees being 2, 3 and 4 percent. In Year 2, the plans are properly combined, resulting in one plan with 400 eligible non-highly compensated employees: 200 from the 2-percent plan and 100 from each of the other two plans. Using the prior year testing method for Year 2, the average ACP is 2.75. [(2 X 200/400)+(3 X 100/400)+ (4 X 100/400)=2.75]

Whenever a highly compensated employee is eligible under more than one plan of the same employer subject to section 401(m), this employee's actual contribution ratio is calculated by treating all the plans subject to section 401(m) as one plan. This rule does not apply to employees who are not highly compensated. Also, this rule does not apply in the case of contributions to plans that may not be aggregated (e.g., ESOPs and non-ESOPs).

Note that a plan may not be restructured to satisfy the ACP test.

401(m)(2)(B)
1.401(m)-1(b)(3), (c)(1), (c)(3), (f)(1)(ii)(B), and (f)(14)
Notice 98-1, 1998-3 I.R.B. 42

(v) Use of Relevant Plan Years

The plan must use the proper plan years when determining the ACPs of the highly compensated employees and of the non-highly compensated employees. As described in II.a., above, if the plan is using the prior year testing method, the ACP of highly compensated employees for a testing year is determined using current plan year

(testing year) data while the ACP for non-highly compensated employees is determined using prior plan year data. Whether an eligible employee is in the highly compensated or non-highly compensated group, or both, is based on his or her status in the current and prior plan years. Similarly, if the plan is using the current year testing method, the ACPs of both highly compensated employees and non-highly compensated employees (and their identity as one or the other) for a testing year are determined using current plan year (testing year) data.
401(m)(2)
Notice 97-2, 1997-2 I.R.B. 22

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c. In addition to satisfying the ACP test, a plan that provides for employee or matching contributions must make such contributions available to employees on a nondiscriminatory basis. The determination of whether a rate of matching contributions is discriminatory is made only after the plan has made corrective distributions of amounts in excess of the ACP test (as well as the ADP test that applies to a cash or deferred arrangement). (See explanation IV.b.) However, some formulas for employee or matching contributions may be, per se, discriminatory, e.g., where the availability of employee or matching contributions is limited to employees with compensation in excess of the integration level under the plan.

A plan is required to satisfy section 401 (a)(4) with respect to the availability of benefits, rights, and features under the plan, including the right to make each level of employee contributions and to receive each level of matching contributions. To satisfy this availability requirement, a benefit, right or feature must be available to a group of employees that satisfies section 410(b).
401(a)(4)
1.401(a)(4)-4
1.401(m)-1(a)(2)

III. Elective Contributions and QNECs

A plan which includes a qualified cash or deferred arrangement (CODA) is subject to the requirements of section 401(k) of the Code. (See Worksheet #12.) Section 401(k) includes an actual deferral percentage (ADP) test which is identical to the ACP test except that elective contributions (i.e., CODA deferrals) are substituted for employee and matching contributions. Under certain circumstances an employer may elect to treat certain matching contributions as elective contributions in calculating the ADP test. Matching contributions that are eligible to be treated as elective contributions are referred to as qualified matching contributions (QMACs). A QMAC is a matching contributions that is both fully vested when it is made and subject to certain distribution restrictions applicable to elective contributions regardless of whether it is actually taken into account for the ADP test. Matching contributions do not violate the "fully vested when made" requirement if they may be forfeited because the contributions on which they were based were excess deferrals, excess contributions, or excess aggregate contributions. QMACs that an employer takes into account for the ADP test are disregarded in performing the ACP test. Thus it is possible that a plan which provides matching contributions may not have to satisfy the ACP test, e.g., where the only matching contributions are QMACs which the employer makes solely to satisfy the ADP test. An employer may also, under certain circumstances, take into account for the ADP test qualified non-elective contributions (QNECs). QNECs are any employer contributions, other than matching contributions, which are not subject to employee election, are fully vested when made, and are subject to the distribution restrictions that apply to elective contributions.

On the 401(m) side, the employer may under certain circumstances, described in section 1.401(m)-1(b)(5) of the regulations, treat as matching contributions for the ACP test elective contributions under a CODA and QNECs. Plans need not describe the extent to which QNECs, QMACs and elective contributions will be taken into account, but the employer must maintain, as a condition of qualification of a CODA under section 401(k) and as a condition of qualification of a plan under section 401(m), records sufficient to demonstrate compliance with these sections, including the extent to which QNECs, QMACs, and elective contributions are taken into account in satisfying the ADP and ACP tests.

If a plan switches from the current year testing method to the prior year testing method in a year beginning on or after January 1, 1999, Notice 98-1 limits the extent to which QNECs, QMACs, and elective contributions may be taken into account in determining the NHCEs' ACP or ADP for the prior year. Refer to Notice 98-1, VII.B.

This part of the worksheet should be completed if the terms of the plan provide that QNECs and/or elective contributions will be taken into account for the ACP test or if the plan provides that the employer will make additional QNECs if necessary to satisfy the ACP test.
401(k)(3)(D), 401(k)(8)(E), 401(m)(3)
1.401(k)-1(b)(4), (5) and (e)(8)
1.401(m)- 1(b)(4), (5) and (c)(2)
Notice 98-1
(Note that safe harbor matching and nonelective contributions (see Part VII) may not be used as QNECs and QMACs to the extent they are needed to satisfy the ADP test safe harbor contribution requirement under Part X of Explanation #12. Notice 98-52)

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a.(i) A QNEC must be fully vested when made, without regard to the participant's age and service and without regard to whether the contribution is actually taken into account for the ACP test. For example, if an employer makes a contribution of $100 which is 50% vested in year one and 100% vested in year two, then no part of the contribution will be treated as a QNEC in either year.
401(m)(4)(C)
1.401(k)-1(g)(13)

(ii) QNECs may be distributed only under the following circumstances:

a. retirement, death, disability, or separation from service;

b. termination of the plan without establishment or maintenance of another defined contribution plan (other than an ESOP, SEP or SIMPLE IRA Plan) and the distribution is in the form of a lump sum;

c. sale of assets of a corporation or sale of a corporation's subsidiary (with respect to an employee who continues employment with the acquiring corporation or subsidiary), but only if the distribution is in the form of a lump sum and the acquiring entity does not maintain the plan after the disposition;

d. attainment of age 59½ (only profit-sharing, stock bonus, and, for distributions made after August 20, 1996, rural cooperative plans).

However, amounts attributable to QNECs may not be distributed on account of hardship for plan years beginning after 1988, unless credited to the employee's account as of a date specified in the plan which may be no later than December 31, 1988, or, if later, the end of the last plan year ending before July 1, 1989.

Under the terms of the plan, the QNECs must be subject to these distribution limitations regardless of whether they are actually taken into account for the ACP test.

401(k)(7)(C), 401(m)(4)(C)
1.401(k)-1(g)(13)

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b. If the plan provides that it will take QNECs and elective contributions into account for purposes of the ACP test, it must limit the QNECs and elective contributions that will be treated as matching contributions to those contributions that are made with respect to employees who are eligible employees under the section 401(m) plan being tested. Furthermore, the plan must provide that such contributions will be treated as matching contributions only if the additional requirements described below and specified in section 1.401(m)-1(b)(5) of the regulations are satisfied.

The plan may incorporate these requirements by reference.

1. The non-elective contributions, including QNECs treated as matching contributions, satisfy section 401(a)(4).

2. The non-elective contributions, excluding QNECs treated as matching contributions for the ACP test and QNECs treated as elective contributions for the ADP test, satisfy section 401(a)(4).

(QNECs allocated to the accounts of NHCEs and HCEs for the same plan year are subject to the requirements of section 401(a)(4) for that plan year even if the plan is using the prior year testing method whereby the QNECs for the NHCEs and HCEs are taken into account for the ACP test in different years.)

3. The elective contributions, including those treated as matching contributions, satisfy section 401(k)(3).

4. The elective contributions, excluding those treated as matching contributions, satisfy section 401(k)(3).

5. The QNECs are allocated to the employee as of a date within the relevant plan year, and the elective contributions relate to compensation that would have been received in the plan year, or compensation for services performed in the plan year that would have been received within 2½ months after the plan year, and are allocated as of a date within the plan year. (See Worksheet #12 and the accompanying explanation regarding when an elective contribution (or QNEC) is considered allocated within a plan year.)

The plan which treats QNECs and elective contributions as matching contributions and the plan to which the QNECs and elective contributions are made must have the same plan year and otherwise could be aggregated for purposes of section 410(b) (other than the average benefits percentage test).

401(m)(3)
1.401(m)-1(b)(5)

IV. Corrections

A plan which would otherwise fail the ACP test can avoid such failure, and the consequent loss of qualified status, in either of two ways. The first method involves making additional employer contributions, in accordance with the terms of the plan, so that the ACP test is passed. This option is generally unavailable to plans using the prior year testing method because additional contributions have to be made to raise the ACP of non-highly compensated employees no later than the end of the next plan year and this period has already expired when the test is run. For example, for the calendar year 2000 testing year, the ACP test will be run in 2001 comparing the year 2000 average ACP of highly compensated employees with non-highly compensated employees' average ACP for 1999. Since contributions taken into account in determining the 1999 average would have had to be made before 2001, if the plan fails the ACP test, it's too late to make additional contributions.

The second method involves distributing or forfeiting the amounts in excess of the ACP limits. A plan may not satisfy the ACP test by failing to make matching contributions that are required under the terms of the plan or by allocating amounts in excess of the ACP limits to a suspense account and then allocating these amounts back to participants' accounts in subsequent years.

The plan need not contain a method for correction if it contains provisions that will ensure the ACP test is always satisfied.

401(m)(3) and (6)
1.401(m)-1(e)(1)
Notice 98-1, 1998-3 I.R.B. 42

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a. If the plan is using the current year testing method, it may provide that, in order to satisfy the ACP test, the employer will make additional matching contributions or QNECs. If this is the case, also complete Part III. of the worksheet. (See the discussion of QNECs in explanations II. and III.) In this event, further correction will not be required.

401(m)(3)
1.401(m)-1(e)(1)
Notice 98-1, 1998-3 I.R.B. 42

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b. A plan may provide that if the ACP limit is exceeded the plan will distribute (or forfeit, if forfeitable) the excess aggregate contributions plus the income that is allocable to these contributions. To avoid a discriminatory rate of match, a plan generally must forfeit matching contributions (even QMACs) that relate to contributions treated as excess deferrals (unless the excess deferrals are for non-highly

compensated employees), excess contributions, or excess aggregate contributions. (See Worksheet #12 for the definition of "excess deferrals" and "excess contributions.") Such a forfeiture will not cause the plan to violate section 411. Excess aggregate contributions means the excess of the total of matching and employee contributions (plus QNECs and elective contributions treated as matching contributions) made on behalf of each highly compensated employee over the employee's maximum permissible contribution ratio determined in accordance with IV.c.(i) below. A distribution of excess aggregate contributions may be made without spousal consent.
401(m)(6)
411(a)(3)(G)
1.401(m)-1(e)(1), (3)(iii)

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c.(i) For plan years beginning after December 31, 1996, the determination of the amount of excess aggregate contributions attributable to each highly compensated employee and the identity of the highly compensated employees who will have excess aggregate contributions distributed (or forfeited, if forfeitable) from their accounts is performed in two separate steps. For plan years beginning before 1997, the amount of excess aggregate contributions was the amount needed to be removed from the accounts of highly compensated employees, working backward from the highly compensated employee with the greatest contribution ratio, so that the ratios remaining would pass the ACP test. The amounts so determined with respect to each highly compensated employee would then be distributed (or forfeited, if forfeitable) to each such highly compensated employee. For plan years beginning after 1996, the amount of excess aggregate contributions is determined in the same way, but the amount so determined is distributed (or forfeited, if forfeitable) to highly compensated employees according to the dollar amount of their contributions used in calculating the ratio, beginning with the highly compensated employee with the greatest amount.

Example:

Ee	Comp.	Ee Contrib.	Match. Contrib.	Contrib. Ratio	Av'g ACP
A	$100,000	$4,000	$2,000	6.00%	
B	$90,000	$3,900	$1,950	6.50%	5.54%
C	$80,000	$2,200	$1,100	4.13%	
D	$20,000	$1,000	$500	7.50%	
E	$10,000	$0	$0	0%	2.50%
F	$10,000	$0	$0	0%	

Using the ACP test, we find that the greatest acceptable ACP is 4.50 (see example in explanation ll.a.) Since 5.54 is greater than 4.50, there are excess aggregate contributions. Assuming that the plan does not provide that correction will be made by the employer's contribution of additional QNECs on behalf of the non-highly compensated employees, thereby increasing the average ACP of the non-highly compensated, the plan must distribute (or, if forfeitable, forfeit) the excess aggregate contributions.

In determining the amount of excess aggregate contributions, the proper procedure is to hypothetically reduce the highest ratio until the maximum allowed percentage (4.50) is achieved, or until the next highest ratio is reached, whichever occurs first ("ratio leveling method"). In this case, if B's contribution ratio is reduced to 6.00, the average ACP will be 5.38. Since this is not sufficient to satisfy the ACP test, A and B's ratios must be further reduced to 4.69%. (4.69 + 4.69 + 4.13 = 13.51; 13.51 ÷ 3 = 4.50). The excess aggregate contributions is the difference between the contributions at the old ratios ($6,000 and $5,850) and the contributions at the new ratios ($4,690 and $4,221), for a total amount of $2,939. This amount must then be distributed (or forfeited, if forfeitable) from the account(s) of the highly compensated employee with the highest dollar amount of contributions used in the ACP test for the plan year until the contributions remaining in such employee's account equals the plan-year contributions in the highly compensated employee's account(s) with the next highest dollar amount ("dollar leveling method"). Therefore, $150 must first be distributed to (or forfeited from, if forfeitable) A, to make A's contributions level with B's, and the remaining amount of excess aggregate contributions, $2,789, is then allocated equally to A and B, so that each has $4,455.50 of employee and matching contributions remaining for the year. (Note that the ACP test is deemed passed after these corrections even though running the test then would not produce a passing average ACP for the highly compensated employees.)
401(m)
1.401(m)-1(e)(2) and (3)
Notice 97-2, 1997-1 C.B. 348

(ii) Section 401(k) of the Code, the regulations thereunder, and Notices 97-2 and 98-1 also provide mechanisms for correcting excess contributions to a qualified cash or deferred arrangement, i.e., elective contributions (and other amounts treated as elective contributions) in excess of the actual deferral percentage (ADP) limits. One method of correcting excess contributions under a qualified cash or deferred arrangement is to recharacterize the excess contributions as employee contributions. If a plan of the employer includes a cash or deferred arrangement that provides for recharacterization, the recharacterized amount is then subject to the ACP limits of section 401(m). The determination of the amounts of excess aggregate contributions resulting from application of the ACP test may be made only after determining the excess contributions to be recharacterized as employee contributions for the plan year.

Example:

Plan X uses a calendar-year plan year and has two eligible employees: A, who is highly compensated; and B, who is non-highly compensated. Plan X contains a qualified CODA and also provides that the employer will match an employee's after-tax contributions to the extent such contributions do not exceed 3% of compensation. Elective contributions that are in excess of the ADP limit are recharacterized and excess aggregate contributions are distributed or, if forfeitable, forfeited. The elective,

employee and matching contributions under Plan X for its 1998 testing year are as follows:

Ee	Comp.	Elect. Contrib.	Ee Contrib.	Match. Contrib.
A	$100,000	$7,000	$5,000	$3,000
B	$20,000	$800	$600	$600

When the employer calculates the ADP test, it determines that there is an excess contribution of $1,000 because the maximum A is permitted to elect to defer is the percentage deferred by B (4%) plus 2. The $1,000 is therefore recharacterized under the plan as an employee contribution and is includible in A's 1998 income. In calculating the ACP test, this $1,000 must be added to the $8,000 employee and matching contributions made on behalf of A for the same plan year. A's limit under the ACP test is $8,000 (6% + 2). Therefore, A has an excess aggregate contribution of $1,000 which must be distributed or forfeited. Note that further correction is needed in this plan because it fails to satisfy the restrictions on multiple use. (See explanation VI.)
401(m)
1.401(m)-1(e)(2)
Notice 98-1, 1998-3 I.R.B. 42

(iii) Any distribution or forfeiture of excess aggregate contributions must include the income or loss allocable to these contributions. Allocable income or loss includes income or loss for the plan year in which the ACP was exceeded. The plan may also be written to include or not include income or loss for the period between the end of the plan year and the date of distribution (the "gap period"). The plan may use any reasonable method for calculating the income or loss, provided the method is used consistently and is the normal method used by the plan for allocating income or loss to participants' accounts. Alternatively, allocable income or loss for the plan year can be determined by multiplying the income or loss for the plan year allocable to employee and matching contributions by a fraction, the numerator being the excess aggregate contributions for the plan year and the denominator being the account balance attributable to employee and matching contributions as of the end of the plan year minus the income or plus the loss allocable to such account balance for the plan year.

The plan may determine the allocable income or loss for the "gap period" in a similar manner, or, alternatively, it may determine income or loss for this period under a safe-harbor method as equal to 10 percent of the income or loss for the past plan year times the number of months between the end of the year and the date of distribution, counting whole months only and treating distributions made after the first 15 days of the month as occurring on the first day of the next month.
401(m)
1.401(m)-1(e)(3)(ii)

(iv) The method of distributing excess aggregate contributions must be nondiscriminatory. If the plan distributes a highly compensated employee's matched employee contributions without forfeiting the corresponding matching employer contributions, it will fail this requirement. A plan may distribute unmatched employee contributions first, or distribute (or forfeit) matching employer contributions before distributing employee contributions. However, if the plan distributes matched employee contributions, there must be a proportional forfeiture of matching contributions.
401(a)(4)
411(a)(3)(G)
1.401(m)-1(e)(4)

(v) A corrective distribution of excess aggregate contributions must be made after the plan year in which the excess aggregate contributions arose and before the close of the following plan year. If a plan fails to correct excess aggregate contributions before the end of the plan year after the year in which they were made, the plan will not be qualified for the year in which the excess aggregate contributions were made and all subsequent plan years until corrected. Further, if excess aggregate contributions are not corrected within 2½ months of the end of the plan year, the employer will be liable for a 10-percent excise tax on these contributions. (However, the tax can be avoided if the employer makes QNECs before the end of the next plan year.) The regulations provide that any distribution of excess aggregate contributions must be designated as such by the employer.
401(m)
4979
54.4979-1
1.401(m)-1(e)(3)(I) and (5)

(vi) The plan must provide that a distribution or forfeiture of excess aggregate contributions will be made on the basis of the respective amounts that are attributable to each highly compensated employee. See explanation at IV.c.(i).
401(m)(6)(C)
Notice 97-2, 1997-2 I.R.B. 22

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d. The plan need not contain methods for correcting a failure of the ACP test if it contains a fail-safe formula (e.g., employee contributions are limited to 2% and 2% QNEC's are given to all employees) or a procedure for prospectively reducing the employee contributions of highly compensated employees so that no excess contributions arise.
1.401(m)- 1(b)(2)

V. Highly Compensated/Compensation

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a. and b. Section 414(q) of the Code defines highly compensated employee. This definition applies for purposes of section 401(m), including the ACP test. Effective for years beginning after December 31, 1996, the term "highly compensated employee" (HCE) means any employee who:

1) was a 5-percent owner at any time during the year or the preceding year, or

2) for the preceding year had compensation from the employer in excess of $80,000 and, if the employer so elects, was in the top-paid group for the preceding year. The $80,000 amount is adjusted at the same time and in the same manner as under section 415(d), except that the base period is the calendar quarter ending September 30, 1996.

In determining whether an employee is an HCE for years beginning in 1997, the amendments to section 414(q) of the

Code described above are treated as having been in effect for years beginning in 1996.

HCE status is determined on the basis of the applicable year of the plan or other entity for which a determination is being made ("determination year") and the preceding twelve-month period ("look-back year"). The plan must take into account employees of all employers aggregated under sections 414(b), (c), (m) and (o), in determining who is highly compensated. Also, for this purpose, the term "employee" includes leased employees unless such employees are covered under a safe-harbor plan of the leasing organization and not covered under a qualified plan of the employer.

414(t)

1.414(q)-1T Q&A 6 and 7

An employer may make a top-paid group election for a determination year. The effect of this election is that an employee (who is not a 5-percent owner at any time during the determination year or the look-back year) with compensation in excess of $80,000 (as adjusted) for the look-back year is an HCE only if the employee was in the top-paid group for the look-back year.

An employer may also make a calendar year data election for a determination year. The effect of this election is that the look-back year is the calendar year beginning with or within the look-back year. This election, once made, applies for all subsequent determination years unless changed by the employer. The plan may not use this election to determine whether employees are HCEs on account of being 5-percent owners.

An employer making one of the elections is not required also to make the other election. However, if both elections are made, the look-back year in determining the top-paid group must be the calendar year beginning with or within the look-back year. These elections must apply consistently to the determination years of all plans of the employer, except that the consistency requirement will not apply to determination years beginning with or within the 1997 calendar year, and for determination years beginning on or after January 1, 1998 and before January 1, 2000, satisfaction of the consistency requirement is determined without regard to any nonretirement plans of the employer.

If a qualified plan contains the definition of highly compensated employee, and an employer makes or changes either a top-paid group election or a calendar year data election for a determination year, a plan must reflect the choices made. Any retroactive amendments must reflect the choices made in the operation of the plan for each determination year.

A highly compensated former employee is based on the rules applicable to determining highly compensated employee status as in effect for that determination year. See section 1.414(q)-1T, A-4 of the temporary Income Tax Regulations and Notice 97-75.

A special transitional rule in Notice 97-75 provides that an employer may make a calendar year calculation election under section 1.414(q)-1T, A-14(b) of the temporary Income Tax Regulations for any year beginning on January 1, 1997 and before January 1, 1998, taking into account the statutory amendments made by the Small Business Job Protection Act of 1996 to section 414(q). The plan must provide for this election.

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c. Section 414(s) of the Code sets forth the definition of compensation that must be used for the ACP test. Even if a plan incorporates the ACP test by reference the plan must still include this definition.

The following definitions of compensation automatically satisfy section 414(s):

1. Compensation within the meaning of section 415(c)(3). For years beginning after December 31, 1997, this definition of compensation includes elective deferrals defined in section 402(g)(3) and amounts deferred under a section 125 cafeteria plan or under a section 457 plan. Under this definition, a self-employed person's compensation is earned income as defined in section 401(c)(2).

2. Wages as defined in section 3401(a) plus all other compensation required to be reported by the employer under sections 6041, 6051 and 6052, or wages as defined in 3401(a), both determined without regard to any rules that limit wages based on the nature or location of employment.

3. A safe-harbor definition that starts with 1. or 2., but excludes all of the following: reimbursements or other expense allowances, fringe benefits, moving expenses, deferred compensation, and welfare benefits. This safe-harbor generally permits the following definition to fall within the scope of section 414(s): Regular or base salary or wages, plus commissions, tips, overtime and other premium pay, bonuses, and any other item of compensation includible in gross income not listed in the safe-harbor exclusions. If this definition is used, any self-employed individual's compensation is to be limited to earned income multiplied by the percentage of nonhighly compensated employees' (NHCEs') total compensation (determined on a group basis) that is included under the plan definition.

Under any of these definitions, the employer can elect to include or exclude elective contributions not includible in income, section 457(b) deferred compensation, and 414(h)(2) pick-up contributions. If any of these are included (excluded), they must all be included (excluded).

Other definitions of compensation may satisfy section 414(s) if they are reasonable, not designed to favor highly compensated employees, and if the facts and circumstances show that the average percentage of total compensation included for highly compensated employees as a group does not exceed the average percentage for nonhighly compensated employees by more than a de minimis amount. In this case, the employer must submit a demonstration that the definition is nondiscriminatory. Imputed compensation may not be used for purposes of the ACP test.

The period used to determine an employee's compensation must be the plan year, the calendar year ending in the plan year, or the portion of either during which the employee was eligible under the plan.

Compensation taken into account cannot exceed the $150,000 compensation limit described in section 401(a)(17), as adjusted by the Secretary for increases in the cost of living. Such adjustments are made in multiples of $10,000. The limit for 2000 is $170,000. See Part X of Explanation #12 for the definition of compensation applicable to the ADP/ACP test safe harbor.

401(a)(17), 401(m)(3)(B), 414(s), 415(c)(3)

1.401(m)-1(f)(2)

1.414(s)-1

1.415-2(d)

VI. Multiple Use

a. If the plan contains a cash or deferred arrangement, Worksheet #12 should also be completed. If the plan contains a cash or deferred arrangement in addition to contributions subject to the requirements of section 401(m), and any highly compensated employee is eligible under both the cash or deferred arrangement and the 401(m) part of the plan, the plan should provide the test for multiple use of the alternative limitation and designate the method of correction to be used if the limitation is exceeded. See c. and d., below.
401(m)(9)
1.401(m)-2

b. If the application or other information indicates that the employer maintains another plan with a cash or deferred arrangement under which a highly compensated employee who is eligible under this plan is also eligible or potentially eligible, the plans must satisfy the requirements relating to multiple use of the alternative limitation. Multiple use is tested separately with respect to plans that are mandatorily disaggregated. (See ll.b.(iii) and (iv), above.) These requirements will be satisfied if both plans, or only the plan that is to make any necessary correction, provide the test for multiple use of the alternative limitation and designate the method of correction to be used if the limitation is exceeded. See c. and d., below.
401(m)(9)
1.401(m)-2

c. Multiple use of the alternative limitation occurs if any highly compensated employee is eligible in an employer's cash or deferred arrangement that is subject to section 401(k) as well as in the employer's plan that is subject to section 401(m) and the sum of the ACP for highly compensated employees and the ADP for highly compensated employees exceeds the aggregate limit. The aggregate limit is the greater of the following:

1. the sum of -
   a) 1.25 times the greater of (i) the ADP for eligible nonhighly compensated employees under the CODA for the prior plan year or (ii) the ACP for eligible nonhighly compensated employees for the 401(m) plan for the plan year beginning with or within the prior plan year of the CODA, and
   b) two plus the lesser of (i) or (ii), above, but in no event more than twice the lesser of (i) or (ii), above; or
2. the sum of-
   a) 1.25 times the lesser of (i) the ADP for eligible nonhighly compensated employees under the CODA for the prior plan year or (ii) the ACP for eligible nonhighly compensated employees for the 401(m) plan year beginning with or within the prior plan year of the CODA, and
   b) two plus the greater of (i) or (ii), above, but in no event more than twice the greater of (i) or (ii), above.

If the plan uses the current year testing method, the aggregate limit is based on the nonhighly compensated employees' ADP and ACP for the current, rather than the prior, plan years. (See explanation II.a.)

Multiple use does not occur if either the ADP or the ACP of the eligible highly compensated employees does not exceed 125% of the respective percentages of the eligible nonhighly compensated employees.

For purposes of the multiple use test, the ADP and ACP of eligible highly compensated employees are determined after correction (distribution, forfeiture, or recharacterization, as applicable) of excess deferrals, excess contributions, and excess aggregate contributions.

A plan that is required to provide the multiple use limitation may incorporate by reference the test in section 1.401(m)-2 of the regulations.
1.401(m)-2
Notice 97-2, 1997-1 C.B. 348, Notice 98-1, 1998-3 I.R.B. 42

d. A plan must designate the method to be used to correct multiple use. The plan may reduce the ADP, treating the reduction as an excess contribution, or the plan may reduce the ACP, treating the reduction as an excess aggregate contribution. If reduction is used, the plan must also designate whether it will reduce the actual deferral ratios (or actual contribution ratios, as applicable) of all eligible highly compensated employees or of only those eligible under both the CODA and the 401(m) plan. Alternatively, if the employer is using the current year testing method (see II.a., above), the employer may contribute QNECs to correct for multiple use in a plan year so that the ACP or ADP of the eligible highly compensated employees does not exceed the percentage of the eligible nonhighly compensated employees by more than 125%.
1.401(m)-2(c)
Notice 97-2, 1997-1 C.B. 348, Notice 98-1, 1998-3 I.R.B. 42

VII. Safe Harbor CODA

Section 401(m)(11) was added by the Small Business Job Protection Act of 1996 to provide, for plan years beginning after 12/31/98, a design-based or "safe harbor" method of satisfying the ACP test. The ACP test safe harbor requires that a plan meet the contribution and notice requirements of the ADP test safe harbor described in Explanation #12 and, in addition, satisfy a special limit on matching contributions. A plan providing for after-tax employee contributions or matching contributions that fail to satisfy the ACP test safe harbor must satisfy the regular ACP test under section 401(m)(2). Explanation #12 should always be referred to in addition to this Explanation because the rules that apply to the ADP test safe harbor, where applicable to the ACP test safe harbor, are noted in Explanation #12.
a. (i),(ii),(iii). Section 401(m)(11) of the Code provides that a plan is deemed to meet the nondiscrimination requirements of section 401(m) with respect to matching contributions if the plan meets an ADP test safe harbor contribution formula, satisfies notice requirements under section 401(k)(12), and provides for a limitation on

matching contributions. A plan may provide for a basic matching formula, an enhanced matching formula, or a nonelective contribution formula, as described in Explanation #12.

However, in order to satisfy the ACP test safe harbor with respect to matching contributions, they must satisfy the remainder of this Part VII.

If after-tax employee contributions are permitted under the plan, it will have to satisfy the ACP test with respect to those contributions.

If a plan changes from a current year ADP or ACP testing method to a safe harbor nonelective contribution method for the plan year, or from a safe harbor matching contribution method to the current year ADP/ ACP testing method, additional rules apply, as discussed in Explanation #12. Explanation #12 should always be referred to in addition to this Explanation for applicable rules.

To determine whether the plan has met all applicable requirements, first see Explanation #12 and complete Worksheet #12.

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b. If the plan provides for matching contributions, unless they are required to satisfy the ADP test safe harbor, they are not required to be immediately nonforfeitable.

(i) These contributions may be subject to a vesting schedule described under section 411 of the Code.

(ii) The ACP test safe harbor is met if (1) matching contributions may not be made with respect to employee contributions or elective contributions that in the aggregate exceed 6% of the employee's compensation, (2) the rate of matching contributions may not increase as the rate of employee contributions or elective contributions increases, (3) at any rate of employee contributions or elective contributions the rate of matching contributions that would apply with respect to any HCE who is an eligible employee is no greater than the rate of matching contributions that would apply with respect to an NHCE who is an eligible employee and who has the same rate of employee contributions or elective contributions and (4) restrictions on elective or employee contributions are limited to those described in Explanation #12, section X, line b.

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c. Even though matching contributions made at the employer's discretion may not be taken into account in determining if the ADP test safe harbor is satisfied, a plan that satisfies the ADP test safe harbor may provide for discretionary matching contributions in addition to any matching contributions needed to satisfy the ADP test safe harbor. However, for plan years beginning after December 31, 1999, a plan fails to satisfy the ACP test safe harbor for a plan year if the plan provides for matching contributions made at the employer's discretion on behalf of any employee that, in the aggregate, could exceed a dollar amount equal to 4% of the employee's compensation.

d. Even if a plan satisfies the ACP test safe harbor with respect to matching contributions, the plan must still satisfy the regular ACP test as described in this Worksheet #11, as modified below, with respect to after-tax employee contributions. The regular ACP test must also be performed if matching contributions fail to satisfy the ACP test safe harbor. If the plan satisfies the ADP test safe harbor or the ADP and ACP test safe harbors but is still required to perform the regular ACP test, the current year testing method must be used. In applying the ACP test, an employer may elect to disregard all matching contributions if the ACP test safe harbor is satisfied, or just matching contributions that do not exceed 4% of each employee's compensation if the plan provides for a matching formula that satisfies the matching contribution requirement under the ADP test safe harbor. QNECS may be treated as matching contributions to the extent permitted under section 1.401(m)-l(b)(5) if they are not needed to satisfy the ADP test safe harbor contribution requirement. In applying the ACP test, matching contributions may not be treated as elective contributions under section 401(k)(3)(D) of the Code to a CODA that satisfies the ADP test safe harbor and elective contributions under a CODA that satisfies the ADP test safe harbor may not be treated as matching contributions under section 401(m)(3).

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e. The restrictions on multiple use under section 1.401(m)-2 do not apply to a CODA that satisfies the ADP test safe harbor. In addition, the restrictions on multiple use under section 1.401(m)-2 do not apply to a defined contribution plan that satisfies the ACP test safe harbor, if the plan does not permit employee contributions. See section VIII of Notice 98-52, 1998-46 I.R.B. 16, for details.

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f. Matching contributions are taken into account for a plan year under the ACP test safe harbor in accordance with the allocation and timing rules of section 1.401(m)-I(b)(4)(ii)(A) of the regulations, which provides that a matching contribution is only taken into account for a plan year if the contribution is allocated to the employee's account under the terms of the plan as of any date within the plan year, is actually paid to the trust no later than 12 months after the close of the plan year, and is made on behalf of an employee on account of the employee's elective contributions or employee contributions for the plan year. However, if it so provides, a plan may match elective and/or employee contributions on a payroll-by-payroll basis instead of an annual basis for purposes of satisfying the ACP test safe harbor, as long as the plan provides that matching contributions for a payroll period are contributed to the plan no later than the last day of the following plan-year quarter (with respect to elective and/or employee contributions made during a plan-year quarter beginning after 5/1/2000).

g. A plan will not fail to satisfy the ACP test safe harbor merely because, after a withdrawal of employee contributions from the plan, the plan suspends additional employee contributions for a period that does not exceed 12 months. See Explanation #12 for additional allowable restrictions on elective contributions, with respect to the safe harbor matching contribution requirement.

h. (i) The rules that apply for purposes of aggregating and disaggregating CODAs and plans under section 401(k) and (m) also apply to the safe harbor rules described under section IX.B. of Notice 98-52.